# Tax Facts

**A knowledge-based series by the Tax and Transfer Policy Institute**

# Good Tax Policy: Taxing Economic Rents

Tax experts often argue that taxing economic rents is a good way for governments to raise revenue. But what are economic rents and when is taxing them a good idea?

## Economic rents

Economic rent is a concept that is separate, but related, to the idea of paying for the temporary use of a good or property, such as renting an apartment. Economic rent can be thought of as 'unearned income'. This is defined as any returns earned from producing a good or service that exceed the costs required to produce it.

For example, the costs of production for a café on a small island without any competitors include: the cost of milk, coffee beans, the coffee machine, cups, renting the land and shop, and paying the barista. To open the shop, the café owner also needs to make enough profit to make it a worthwhile venture. Worthwhile might mean that the owner can make as much profit as they would make if they took up a job for a regular salary with an employer. The amount of profit required to make investing in the café worthwhile is also known as the 'normal rate of return'. The café's revenue from sales needs to cover both the costs of production and this normal rate of return for the café to be worth opening. The café's revenue needs to continue to meet these costs and to provide this normal rate of return to be worth keeping open.

If however, the café owner chose to take advantage of the monopoly achieved by being the only café on the island, and arbitrarily charged an extra dollar for every coffee, the extra money earned would be economic rent. That is, it would be a return (profit) which exceeded the costs required to make it worthwhile to produce and sell the coffee. The extra dollar per coffee would not be a payoff for additional effort expended, but rather, income earned because the café had a monopoly.

The most difficult and contested part of defining economic rent is that it requires a definition of a 'normal rate of return'. The normal rate of return describes the return that is needed to make funding or investing in producing something worthwhile. In the case of the café, if the café was never going to be profitable then it is unlikely that the owner would be able to get a loan to fund opening the café. The amount of profit required to make opening the café feasible from a financial point of view is the 'normal rate of return'. Generally it is agreed that this 'normal return' is at least the return that an investor would get if they invested in a government bond, which is essentially risk-free, plus some additional return proportionate to the risk the investor is taking. The normal rate of return is not an economic rent, because without it the good or service would not be produced.

## Why do economic rents exist?

In a competitive market, economic theory suggests that producers should compete on prices until prices fall to the minimum required to produce a good or service. Why then do economists also expect to observe economic rents in some circumstances? Economic rents are believed to arise from market imperfections, such as when a producer has a monopoly, there is asymmetric information, there are high fixed costs or entry costs or the producer has access to an exclusive resource or technology. Economic rent is most commonly associated with a producer having privileged access to a scarce resource. For instance, in the case of the café on the island, the café owner may have been granted access to the only land zoned for a café on the island. On the other hand, the café might have a monopoly because the high costs of setting up a second café on the island deter competitors (but this is less likely).

Government policy can produce economic rents when it confers advantage to one group over another or introduces regulation that creates high fixed costs or barriers to entry. The café discussed in the previous paragraph provides an example of this. If the café has a monopoly due to zoning laws, the café's ability to extract economic rents is a result of government regulation.

## What are some examples of economic rents?

Economic rents can be divided into two categories: immobile (location-specific) and mobile. Location-specific rents arise from production activities that cannot be moved. The right to use natural resources, such as mining rights for a country's minerals, can produce location-specific rents. Many different types of location specific rents exist, for instance, a rent can arise due to a consumer preference for goods produced in a certain region.

Mobile rents are not tied to a particular location. In some cases, mobile rents are firm-specific. Examples include possession of a patent, a brand, or management know-how. Each of these cases is a potential source of economic rent because it allows a firm to produce a good that their competitors cannot, or to produce it more cheaply, allowing the firm to make excess profits.

## Why is it a good idea to tax economic rents?

Economic rents represent an opportunity to receive unusually high returns, above and beyond the cost of producing a good. As a result, economic theory suggests that there is a strong incentive for producers to continue exploiting the profit opportunities associated with an economic rent. Taxing an economic rent at a rate of 40% still leaves 60% of the unusually high return for the producer. This means that there is still a strong incentive to continue producing the good, even though some of the unusually high return has been transferred to the tax office. As long as some portion of the economic rent remains, producers would be expected to continue producing. As a result, a tax on economic rents should not change behaviour. As described in our **deadweight loss** tax fact, taxes that do not change people's behaviour are an efficient way to raise revenue and avoid the social welfare loss associated with taxes that cause deadweight loss. Taxing economic rents is also an equitable way of raising tax revenue because it captures excess profits made by certain firms.

## What are the challenges associated with taxing rents?

- *Mobile economic rents, by definition, can move*. While taxing economic rents will not make a project unprofitable, it will reduce profits. Since Australia is a small open economy, any rent tax imposed on these mobile rents may create an incentive to move production to lower-taxed countries. This means that taxing mobile rents may change investor and firm behaviour, producing deadweight loss. As a result, governments typically prefer taxing location-specific rents, which arise from production activities that cannot be moved.
- *Determining the normal rate of return is complex*. Projects have different normal rates of return based on their risk level. This means that government cannot accurately target rents by simply taxing returns that are above the perceived normal return. To address this, there are other approaches that the academic literature has proposed, such as a cash flow tax. Cash flow taxes tax the difference between a firm's revenue and its expenditure. In the long run, this effectively taxes any rents that are received by the firm.
- *Rents can change over time*. Technology can diminish or increase economic rents over time. Natural resources are also fixed in quantity. These factors are important to bear in mind from a revenue raising standpoint since they are potentially more volatile than other sources.

## An Australian case

Australia's Petroleum Resources Rent Tax is an example of an Australian tax which is designed to capture the location-specific rent associated with the use of Australia's petroleum reserves. It is levied at a rate of 40% on the positive annual net cash flow of each petroleum project, effectively taxing rents.

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